Do Americans Save Too Little?

B. Douglas Bernheim & John Karl Scholz**

Since the mid-1980s, low rates of national saving in the United States have generated an enormous amount of concern among both economists and policymakers. Proposals to address these concerns fall into two broad categories: policies designed to increase public saving and policies intended to promote private saving. The former is synonymous with deficit reduction, while the latter includes tax incentives, pension policy, and strategies for discouraging the use of private debt. Some economists argue that deficit reduction is the most reliable and efficacious method of increasing national saving (Summers, 1985), while others maintain that restoring adequate rates of private saving is essential (Bernheim, 1991). To evaluate the merits of strategies that target private saving, we must resolve two issues. First, aside from the obvious fact that private saving is one component of national saving, is there reason to be concerned about the rate of private saving? Second, are there any effective and reliable methods of promoting private saving?

*B. Douglas Bernheim is the John L. Weinberg Professor of Economics and Business Policy, Princeton University. John Karl Scholz is an assistant professor of economics, University of Wisconsin, Madison. When this article was written, Bernheim was a visiting scholar in the Research Department of the Philadelphia Fed. The authors gratefully acknowledge the work of Robert Avery and Arthur Kennickell, who developed a clean copy of the 1983-86 *Survey of Consumer Finances* and provided extensive documentation.

THE ADEQUACY OF HOUSEHOLD SAVING

According to common wisdom, Americans consume too much and save too little. This impression is largely traceable to widely publicized statistics on aggregate personal saving. International comparisons reveal that U.S. households save significantly less than their foreign counterparts. Between 1980 and 1991, Americans saved 6.4 percent of disposable personal income, compared with 9.8 percent for OECD Europe and 15.7 percent for Japan (Organization for Economic Cooperation and Development, 1992). And since the mid-1980s, the rate of household saving in the U.S. has been well below its historical average (Figure 1).

Although these statistics raise legitimate concerns, they do not provide definitive evidence of a problem. As measured, personal saving excludes capital gains. Thus, in principle, households can accumulate wealth at a rapid rate even when their measured rates of saving are low. Rates of personal saving can also vary across both time and countries for reasons unrelated to the adequacy of saving considered from the perspective of individual households.[1] To understand this second point, consider the following hypothetical example. Envision two countries, A and B, that are identical in all respects except that the elderly make up a larger fraction of the population in A than in B. Since households tend to accumulate wealth prior to retirement and spend wealth thereafter, we would expect to observe a higher rate of aggregate personal saving in country B. Indeed, in an economy with no growth in either population or productivity, dissaving by retirees could completely offset saving by workers: in principle, regardless of how well individual households prepared for retirement, we might observe virtually no aggregate personal saving. Thus, ultimately, we can judge the adequacy of personal saving only by examining microeconomic data on the behavior of individual households.

Generally, the available evidence suggests that American workers have prepared poorly for retirement. Diamond (1977) found that, during the 1960s, 40 percent of couples and more than 50 percent of unmarried individuals reported that after retirement they received no money income from assets. At age 60, nearly 30

FIGURE 1
Rate of Personal Saving, National Income Accounts

[1]Indeed, Meyer, 1992, argues that demographic differences account for roughly one-third of the gap in personal saving relative to GNP between Germany and the U.S. during the 1980s and roughly two-thirds of the gap between Japan and the U.S.

percent of middle-class individuals lacked sufficient wealth to replace two years' worth of income. Similarly, Hamermesh (1984) concluded that, during the 1970s, most elderly individuals had not accumulated sufficient resources to sustain their accustomed standards of living. Indeed, consumption shortly after retirement exceeded the highest sustainable level of consumption by an average of 14 percent. Hamermesh also found that within a few years of retirement most retirees were forced to reduce their expenditures substantially.[2]

Asset Accumulation Profiles. More recent evidence on the adequacy of saving appears in Bernheim and Scholz (1992a). Using an elaborate model of household decision-making, we simulated asset accumulation profiles (trajectories) that households should follow (given the assumptions of the model) to prepare adequately for retirement.[3] We then compared these simulated profiles with ones estimated from recent surveys of households' actual saving behavior. (For a more detailed description of the model, see *Explanation of the Model*.)

The simulation model describes only the accumulation of assets for retirement. There are, of course, many reasons to save. Households should take precautions against the possibility of illness, layoff, disability, death, and other risks for which they are imperfectly insured. In addition, most households accumulate resources to pay for large expenses such as college tuition or the purchase of an automobile. For some individuals, saving is motivated in part by the desire to leave a substantial bequest upon death. Unfortunately, when examining the data, we cannot determine whether particular assets were accumulated for retirement or for some other purpose. Consequently, the comparison between estimated trajectories and simulated trajectories may provide an overoptimistic picture of the adequacy of household saving.

We show graphic depictions (Figures 2 and 3) of a simulation for a household with the following characteristics: age 27 (as of 1991), two years of college education, married, two workers with total current earnings of $60,540, and the primary earner covered by a private pension plan. This household's optimal trajectory of consumption and after-tax earned income (including pensions and Social Security) is shown in constant 1991 dollars (Figure 2, page 7).[4] Note that after-tax earnings rise steeply early in life. Earnings growth continues at a reduced level until the individual reaches age 55, at which point it begins to fall. After retirement, earned income consists of Social Security and private pension benefits. Since pensions are not perfectly indexed for inflation, real benefits decline gradually over time.

As a direct consequence of the household's rapid earnings growth early in life, it saves nothing for retirement prior to age 30. Between ages 30 and 80, the consumption trajectory is relatively flat. This flat trajectory reflects the household's preference for a stable standard of living. However, during the 30s and 40s, consumption is elevated relative to the 60s and 70s. This pattern results from changes in household composition: between the ages of 30 and 50, the typical household incurs significant child-rearing costs. Consumption declines rapidly after age 80 until, at age 101, it matches after-tax retirement benefits. Falling survival probabilities cause this end-of-life decline. Since there is a relatively low probability of reaching age 90,

[2]Other economists have reached somewhat more optimistic conclusions. See Kotlikoff, Spivak, and Summers, 1982.

[3]Development of this model was sponsored by Merrill Lynch & Co., Inc., and is described in Bernheim, 1992b.

[4]We use the word "trajectory" to describe the manner in which an economic variable, such as consumption, income, or wealth, evolves as the household ages.

Explanation of the Model

Our simulation model reflects a "life-cycle" approach to the average household's financial decision-making process. It takes into account the fact that predictable changes in household earnings resulting from age and stage of career may not match up very well with consumption needs. For example, the financial needs of most households are usually highest during the child-rearing years, while household earnings usually reach their highest point after children have left home. The household varies its rate of saving in order to achieve a better match between the ability to spend and the need to spend. It saves least in years when spending needs are high and more in years when spending needs decline.[a] The model forecasts households' future income and derives the optimal consumption (and thus saving) trajectories consistent with those income forecasts.

Our life-cycle calculations account for a variety of current and future household characteristics, including age, income level, pension coverage, education, marital status, gender (if unmarried), and household composition (the numbers of children and dependent adults).[b] The model also projects and adjusts for future macroeconomic conditions that ought to affect savings behavior, including interest rates, inflation rates, and baseline wage growth. In addition, the model provides a realistic treatment of income taxes, payroll taxes, and social security benefits.

To conduct simulations, one must also choose values for several "preference parameters." For example, the model includes a parameter commonly known as the "pure rate of time preference," which expresses the value that a household places on future consumption relative to current consumption.[c] The value of this particular parameter has a profound effect on the simulation results. When the pure rate of time preference is sufficiently low, it is optimal for the household to save nothing. For this reason, the absence of saving is not necessarily the result of irrationality. Rather, it may simply reflect impatience.

We have calibrated our model (that is, chosen values for the preference parameters) so that the simulations produce a standard of living during retirement that is roughly comparable to the standard of living enjoyed prior to retirement.[d] Consequently, it is appropriate to interpret our results as follows: if households fall significantly short of simulated asset accumulation targets, they will ordinarily be forced to accept serious reductions in their standards of living after retirement.

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[a]When spending needs are sufficiently high relative to income, a household may wish to liquidate or borrow against accumulated assets. Once assets are exhausted, it may be optimal for the household to borrow against future income. However, for most households, it is extremely difficult to obtain sizable unsecured loans. Our model therefore imposes a "liquidity constraint," which ensures that the household's net wealth remains positive.

[b]Our calculations reflect the fact that larger households benefit from significant economies of scale. Research on household scale economies indicates that two adults in a household can obtain the same standard of living as one adult living alone with added expenditures of slightly more than 40 percent. Research also shows that the financial impact of adding one adult to a household is roughly equivalent to adding 2.5 children. See Cutler and Katz, 1992.

[c]Other important preference parameters include a minimum subsistence level for consumption and a parameter known as the "intertemporal elasticity of substitution," which measures the extent to which the household's willingness to trade off current consumption for future consumption is affected by the level of current consumption relative to future consumption.

[d]Specifically, we use a pure rate of time preference equal to the product of 0.99 and one-year gender-specific survival probabilities (taken from standard life tables). The minimum consumption level is set equal to $10,000 (measured in 1991 dollars), and is adjusted for family size. A value of 0.25 is used for the intertemporal elasticity of substitution.

the household would prefer to accept a lower standard of living at age 90 and later (if it survived that long) in favor of a higher standard of living earlier in life.

The associated optimal trajectory of retirement assets is also depicted (Figure 3). Assets accumulate at an increasing rate from age 30 to retirement, peak at retirement, then decline steadily until they are exhausted at age 100.

We then estimated actual asset trajectories using data from the *Survey of Consumer Finances* (SCF) for 1983 and 1986.[5] The Board of Governors of the Federal Reserve (in conjunction with other federal agencies) sponsored the SCF, recognized as one of the best available sources of data on household balance sheets.[6]

[5]Our measure of accumulated net worth includes stocks and mutual funds, bonds, checking and savings accounts, IRA and Keogh accounts, money market accounts, certificates of deposit, profit-sharing and thrift accounts, the dollar cash value of whole life insurance, and other financial assets, as well as equity in property (other than primary residences) and business assets, less credit card, consumer, and other debt. This measure excludes all assets and liabilities associated with homes and vehicles, since households appear to have a strong aversion to paying living expenses during retirement by drawing down the equity in their homes (see Venti and Wise, 1989). Also, it seems likely that few individuals save for retirement by accumulating wealth in the form of vehicles. Accumulated wealth for 1983 is expressed in 1986 dollars using the Consumer Price Index.

[6]See Avery and Elliehausen, 1988, and Avery and Kennickell, 1988, for a more complete discussion of the SCF.

FIGURE 2
Simulated After-Tax Income and Consumption Trajectories

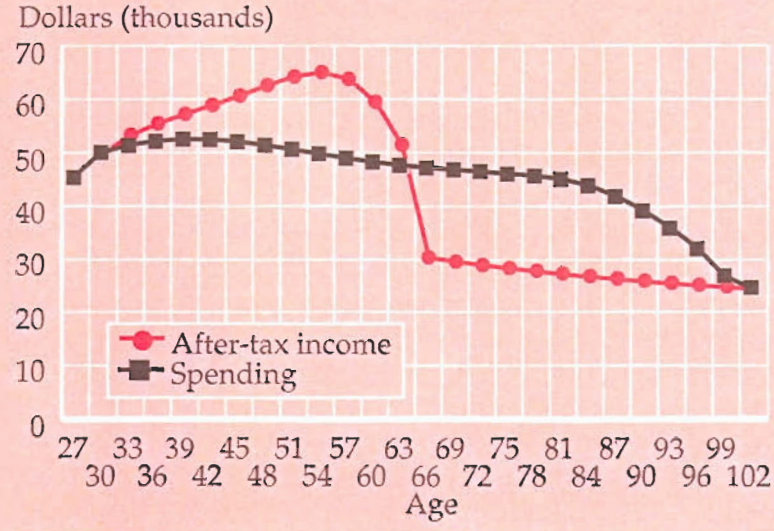
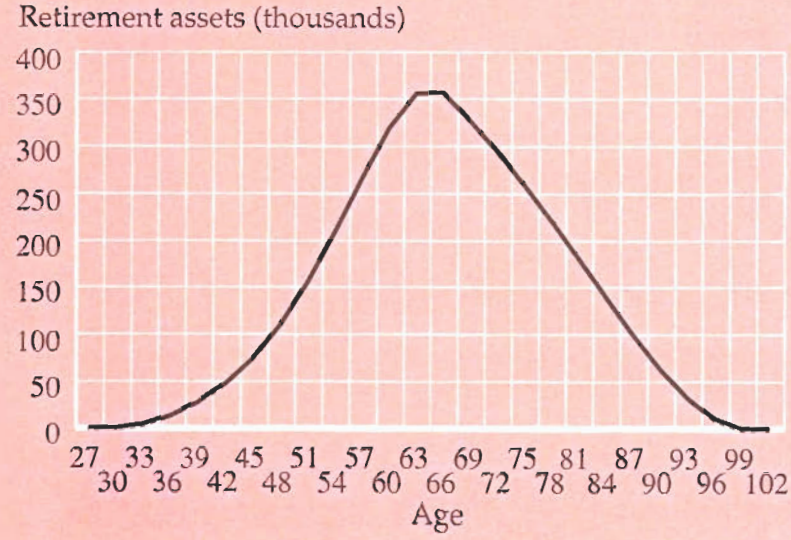


FIGURE 3
Simulated Wealth Trajectory



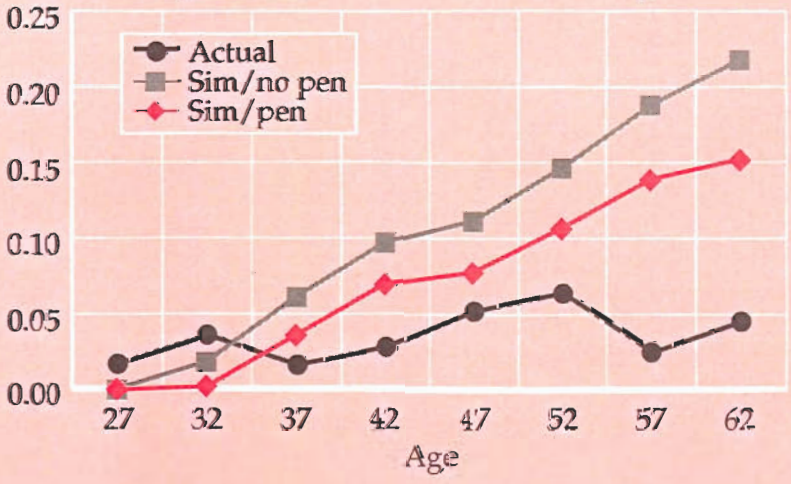
Our analysis allows us to compare actual and simulated optimal behavior. The results for households in which the primary worker has not completed college are shown in Figure 4. In this figure, "actual" refers to the estimated change in wealth (measured as a fraction of wage income) for the representative household within each age group (calculated using the SCF); "Sim/no pen" indicates the simulated change in wealth (again as a fraction of wage income) for a representative household without pension coverage for the primary earner; and "Sim/pen" denotes the simulated change in wealth for a representative household with pension coverage for the primary earner. Note that the simulated change in wealth rises steeply with age. This steep increase in assets results from two factors. First, during most of an individual's working life wages rise more rapidly than consumption (see Figure 2). Second, reinvested capital income rises as the household accumulates assets. In contrast, the estimated change in wealth does not vary significantly with age. By the time the household reaches middle age, simulated asset accumulation exceeds actual accumulation by a wide margin.[7] Overall, between 1983 and 1986, households without a college education saved far less than the simulation model predicts (Figure 4).

Results for households in which the primary earner completed college are depicted in Figure 5. The contrast between Figures 4 and 5 is remarkable. In cases where the household head completed college, both simulated and estimated changes in wealth rise steeply with age. Moreover, simulated asset accumulation tracks actual asset accumulation remarkably well. Taken at face value, Figure 5 suggests that highly educated households saved adequately for retirement between 1983 and 1986.

Although it is tempting to conclude that inadequate saving is largely confined to those without a college education, this conclusion must be tempered by two considerations. First, as is apparent from Figure 1, personal saving declined sharply after the 1983-86 period on which the estimates are based. Using a sample of relatively young individuals (ages 25 through 44) surveyed in early 1992, Bernheim (1992a) found much more pervasive evidence of inadequate saving. Second, the model probably understates the amount of wealth that each household ought to accumulate. The most obvious reason for this discrepancy is that the

FIGURE 4

Rates of Asset Accumulation No College Degree



[7] Although estimated asset accumulation is actually higher at ages 27 and 32, this is of little consequence; recall that the data reflect saving for a variety of purposes aside from retirement.

simulations envision retirement planning as the sole motive for saving.[8]

To the extent that many households prepare poorly for retirement, there is cause to be concerned about the rate of personal saving, per se. Historically, pension policy and tax policy have been the two most important tools for stimulating personal saving. We will discuss evidence on the efficacy of each of these strategies in turn.

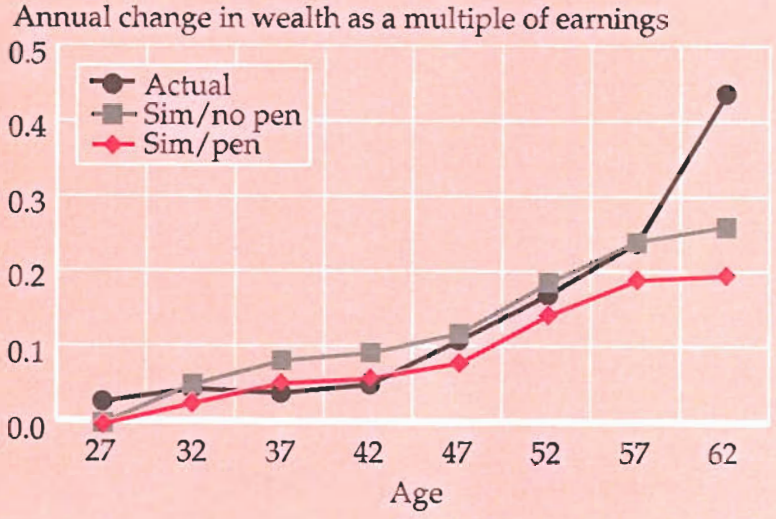
PENSION POLICY

In recent years, the accumulation of assets in private pension plans has accounted for a substantial fraction of personal saving (Bernheim and Shoven, 1988). This observation raises the possibility that policies affecting private pensions may have powerful effects on aggregate personal saving. Whether these effects would actually materialize depends on the way workers would respond to an expansion of private pension coverage. Economic theory suggests that such an expansion would simply crowd out other forms of personal saving: once workers realize that their employers are, in effect, saving for them, workers will save less themselves. The simulation results presented in the previous section illustrate this principle. However, previous studies of personal saving have generally failed to find evidence to support the notion that private pensions significantly reduce other forms of personal saving.[9] Depending on whether we credit the theoretical analysis or the empirical studies, we can reach dramatically different conclusions about the effect of pension policy on aggregate personal saving.

The analysis described in the preceding section raises an intriguing possibility: if the behavior of those with a college education (and higher average incomes) conforms to the predictions of standard economic theories, while the behavior of those without a college education (who have lower average incomes) does not, perhaps private pensions do displace personal saving among the college educated, but not among the rest of the population. In that case, pension policy could be an effective tool for stimulating total personal saving, so long as it is primarily used to pro-

FIGURE 5

Rates of Asset Accumulation
College Degree



[8]In addition, it is quite likely that the model overstates mortality probabilities (since it does not make any allowance for the fact that these probabilities are projected to decline in the future), understates the importance of health and long-term care costs for the elderly, and fails to consider the effects of mounting economic pressures that may force Congress and employers to scale back existing retirement benefits.

[9]See, for example, the review in Shefrin and Thaler, 1988, particularly pages 622-24.

vide incentives for expanded coverage among lower income, generally less educated, workers.

To investigate this idea, we estimated equations that explained the median value of household wealth as a function of age, total household earnings, private pension coverage, and educational attainment. We then used these equations to project asset accumulation profiles.

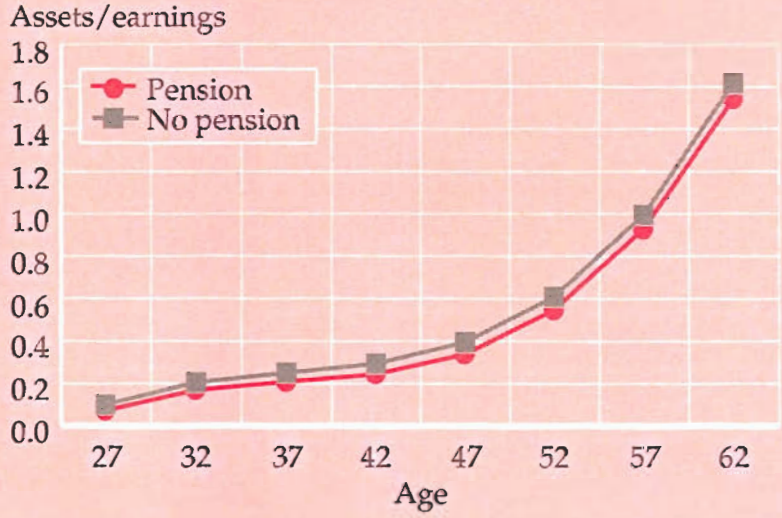
Results for the median household in which the primary earner has not completed college are presented in Figure 6. Note that pension eligibility has little or no effect on the actual path of household wealth accumulation. From a statistical perspective, the estimated equation supports the notion that, at every age, less educated households with private pensions accumulate wealth at the same rate as those without private pensions.

Results for households in which the primary earner has completed college are displayed in Figure 7. Statistically, the data decisively reject the premise that the rate of asset accumulation is unrelated to pension eligibility. Note that those eligible for pensions accumulate resources at a significantly slower rate than those without pensions. Remarkably, at age 62, the gap between the assets of these two groups is almost identical in magnitude to the predicted gap that emerges from our computations. These patterns are strongly consistent with the view that private pensions displace other personal saving for college-educated households.[10] These results suggest that other studies may have failed to find a significant saving displacement effect simply because they did not distinguish between households on the basis of education (or permanent income).

The contrast between Figures 6 and 7 points to a clear and important conclusion for pension policy: private pensions displace personal wealth accumulation only when the head of the household is college-educated. This observation aligns with the evidence on the adequacy of personal saving described in the first section of this article. Indeed, our evidence broadly supports a more general conclusion: college-educated households behave in the manner predicted by standard economic theories of saving, while less well-educated households do not. Past and current policies have been more successful at stimulating the expansion of pension coverage among college-educated

[10]It is unlikely that the observed relationship between pension coverage and saving results from spurious factors, since such factors would presumably also have produced the same patterns for less educated households.

FIGURE 6
Estimated Wealth Trajectories
No College Degree



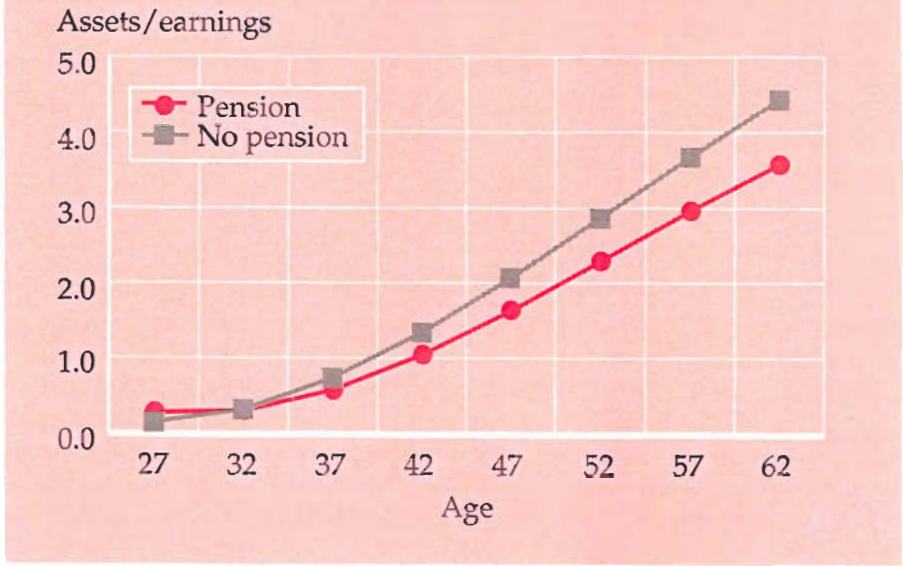
workers than among those with less education. Analysis of the SCF data reveals that 75.2 percent of college-educated husbands are covered by private pensions. In contrast, only 55.7 percent of husbands who lack a college education are covered by private pensions. In other words, the current system is quite effective at providing pensions to those individuals who reduce other saving in response and much less effective at providing coverage to those individuals for whom pensions would represent incremental saving.

TAX POLICY

The most commonly discussed strategies for stimulating personal saving entail reductions in the taxation of capital income. Economic theory suggests that households will respond to a higher after-tax rate of return on savings by increasing future consumption relative to current consumption. However, theory does not necessarily predict that current saving will rise. (The reason is that a higher rate of return will make wealth grow more rapidly, enabling greater future consumption, even if the household were to save a bit less out of its current income.) Indeed, empirical estimates of the sensitivity of saving to the after-tax rate of return (called the interest elasticity of saving) vary widely (Boskin, 1978; Summers, 1981; and Hall, 1988).

Individual Retirement Accounts. Most current proposals to provide tax incentives for saving are patterned after individual retirement accounts (IRAs). IRAs were established as part of the 1974 Employee Retirement Income Security Act to give workers not covered by employer-provided pension plans added incentives to accumulate resources for retirement. In 1981, IRA eligibility was extended to all taxpayers. Subsequently, the Tax Reform Act of 1986 curtailed the tax-deductibility of IRA contributions for high income households. The existence of an income cap for IRAs raises an important question: does the sensitivity of saving to the after-tax rate of return vary systematically across income classes? The answer to this question makes it possible to determine whether the current system targets the most responsive groups.

FIGURE 7
Estimated Wealth Trajectories
College Degree



Simulations based on the model described in this article suggest that higher income individuals will be much more responsive than lower income individuals to changes in the after-tax rate of return. Averaging across individuals with pensions and individuals without pensions, the simulations imply that saving by 35-year-old, college-educated households would increase by 10.2 percent in response to a permanent one-percentage-point in-

crease in the before-tax rate of return, while the saving of 35-year-old, high-school-educated households would *fall* by 4.5 percent. Consequently, policies that provide tax incentives for saving exclusively to lower income households exclude those individuals most likely to increase saving in response to tax incentives; indeed, such policies could actually reduce aggregate personal saving.

This positive relationship between income and the interest elasticity of saving results from a natural economic consideration, rather than from some peculiar feature of the simulation model. It is natural to assume that when planning for the future, most households are concerned first and foremost with saving enough to assure themselves of some minimum standard of living. As lifetime resources increase, households have more discretion to allocate resources in a manner that increases consumption above and beyond this minimum standard both today and in the future.

For low income households, saving to achieve some minimum future consumption is probably far more important than saving to fund incremental consumption. Saving to provide for minimum consumption is, in effect, saving for a fixed target. An individual who saves to achieve some target will reduce saving in response to an increase in the rate of return (Bernheim and Shoven, 1988). Thus, because target saving dominates the simulated behavior of these households, they exhibit a low or negative interest elasticity of saving. For high income households, however, saving to fund incremental consumption is probably far more important than saving to achieve the minimum consumption target. Incremental saving dominates the simulated behavior of these households. Thus we observe a high interest elasticity of saving among higher income, well-educated households. Discretionary saving to finance consumption over and above the target responds positively to an increase in the rate of return.

Of course, in the preceding sections, we observed that the behavior of less educated (generally lower income) households may not conform to standard economic theories. Although this finding reduces our faith in the applicability of our simulation results, it does not reverse our conclusions concerning the interest elasticity of saving. The notion that households will respond to a change in the after-tax rate of return is predicated on the assumption that households rationally anticipate and plan for future economic contingencies. To the extent that this assumption proves incorrect, there is no particular reason to believe that lower income households will respond to a change in the after-tax rate of return in the first place.

Tax Policy Initiatives. Two prominent current policy initiatives would reverse the direction of the 1986 reforms and improve tax incentives for saving to households in higher income brackets. Family saving accounts (FSAs), proposed by the Bush administration, would allow single individuals with adjusted gross incomes (AGI) below $60,000 and married couples with AGI below $120,000 to make contributions of up to $2500 to qualified accounts. The FSA proposal is an example of a "back-loaded" system: contributions are nondeductible, but accumulated funds are not taxed upon withdrawal. An alternative proposal, the Bentsen-Roth "super-IRA," would allow individuals to contribute up to $2000 to either a traditional or a back-loaded IRA.[11]

[11]On August 3, 1992, the Senate Finance Committee approved H.R. 11, the Revenue Bill of 1992. Like the Bentsen-Roth super-IRA, this bill would restore the deductibility of IRA contributions for all taxpayers and establish new back-loaded IRAs. Contributions to back-loaded IRAs could be withdrawn without penalty after five years. The bill would also allow taxpayers to make penalty-free early withdrawals from IRAs for the purchase of a first house, for higher education expenses, for medical expenses, and for long spells of unemployment.

Unfortunately, there are sound conceptual reasons to doubt the effectiveness of extending eligibility for IRA-style accounts to higher income households. First, contributions are capped. Under the current system, a single taxpayer, for example, can make no more than $2000 in tax-deductible contributions. For an individual taxpayer who would have saved more than $2000 in the absence of IRAs, the availability of an IRA does not affect the costs or benefits that might result from an additional dollar of saving and, therefore, provides no incentive on the margin for the taxpayer to increase saving. In such cases, the IRA constitutes a "giveaway" of public funds (it reduces federal tax receipts but does not promote more saving). In addition, the IRA may actually induce the taxpayer to increase consumption, since it increases his or her total after-tax resources. For both of these reasons, the IRA would contribute to a lower rate of national saving. These concerns are of little significance for low income households, since few of them would save more than $2000 in the absence of the program. It is far more likely that high income households would save more than the contribution limit. Thus, IRA-style proposals may be a particularly ineffective vehicle for providing tax incentives for saving to high income households.

A second reason for doubting the effectiveness of IRA-style accounts for high-income households is that even if such a taxpayer would not (in the absence of IRAs) have saved more than the IRA contribution limit in a given year, he or she could take full advantage of the IRA deduction either by financing contributions with previously accumulated assets or by borrowing. Indeed, the 1991 *Tax Guide for College Teachers* devotes a full page to the issue "What If You're Short of Cash to Fund Your IRA?" (pp. 229-30). The Guide describes an IRS private letter ruling that allows households to finance their IRAs by borrowing. Contributions funded either by shifting existing assets or by borrowing do not increase household saving. Instead, by reducing federal tax receipts, they add to the federal budget deficit and depress national saving. Once again, it is more likely that high income households (who possess greater wealth, financial sophistication, and access to credit markets) would engage in borrowing or asset shifting and thus defeat the purpose of the program.

Empirical evidence on the efficacy of IRAs is mixed. Gale and Scholz (1992) find little evidence that IRAs stimulated household saving between 1983 and 1986. Venti and Wise (1986, 1987, 1990, 1991) and Feenberg and Skinner (1989) suggest that most IRA contributions during this period represent net increases in household saving. Joines and Manegold (1991) conclude that the effects of IRAs on household saving are unlikely to be as large as the estimates of Venti and Wise and may be as small as the estimates of Gale and Scholz.

An alternative proposal to promote household saving, based on "premium saving accounts" (PSAs), is described in Bernheim and Scholz (1992b). A PSA system would require each taxpayer to save—in total—some fixed amount (the floor) before becoming eligible to make contributions to a tax-favored account. The taxpayer would be eligible to contribute each additional dollar of saving to the tax-favored account, up to some limit (the ceiling). These floors and ceilings would rise with AGI and certain types of capital income. As with IRAs, capital income accrued on balances held in PSAs would be exempt from taxation.[12]

The use of both floors and ceilings would

[12]With this essential structure, a PSA system could be either front-loaded or back-loaded. Penalties could be established to lock funds into tax-favored accounts for relatively short periods (e.g., seven years) or until some age close to retirement (perhaps age 59 1/2). Accounts could be established for specific purposes (e.g., retirement, purchase of a house, college education), or the accounts could be unrestricted.

create "windows" of program eligibility. Consider, for example, a married couple with an AGI of $80,000. They might face a floor of $8000 and a ceiling of $12,000. Should they save less than $8000 in the corresponding tax year, they would not be eligible to make any contributions to a tax-favored account. If, on the other hand, they saved $9500, they would be eligible for favorable tax treatment on $1500. If they saved more than $12,000, they would be eligible to make the maximum contribution of $4000 (the difference between $8000 and $12,000).

The most important distinctive feature of a PSA system is that floors and ceilings would vary with AGI. Eligibility windows could be positioned to maximize, within each income class, the number of households receiving tax breaks on the marginal dollar of saving. Doing so would maximize the incentive to save more. Higher-income taxpayers would not be deprived of tax incentives for saving; rather, they would simply be required to save much larger fractions of their incomes before becoming eligible for PSAs. It would also be much more difficult for households to take advantage of tax-favored PSA accounts by shifting assets or by borrowing because eligibility would be based on total saving. An individual cannot increase his total saving by shifting assets from one account to another or by borrowing to invest.[13]

To implement a PSA system, one needs to measure a household's total saving. Bernheim and Scholz (1992b) propose the following measure:[14]

Net purchases of assets (i.e., total purchases minus total sales) for assets on which investors receive capital gains and losses

plus

The January 1 to January 1 change in cash account balances (e.g., bank accounts),

minus

The January 1 to January 1 change in total debt (mortgages, consumer credit, etc.).

In effect, saving is defined as the incremental resources that an individual sets aside in any year over and above reinvested capital gains.[15,16]

Now we'll evaluate the effects of three distinct strategies for promoting household saving: an IRA-like program with an AGI cap (hereafter referred to as the "standard IRA" system), an IRA-like program without an AGI cap (hereafter referred to as the "universal IRA" system), and a PSA system. We compare the cost-effectiveness of extending tax incentives for saving to higher-income taxpayers through universal IRAs and PSAs.

Sample schedules that define eligibility windows for each level of AGI for a PSA system are given in Table 1. Separate schedules are given for married couples and single individuals. The schedules are chosen to maximize the ben-

[13]The administrative feasibility of monitoring total saving for each taxpayer is discussed in Bernheim and Scholz, 1992b.

[14]Many economists would define saving as the change in the stock of wealth between two points in time. If one adopts this definition, saving is very hard to measure: one would need to assess the market value of all assets every year. The definition used in the text represents a compromise between economic logic and administrative feasibility.

[15]Note that it is possible to compute this measure of saving without assessing the value of unrealized capital assets, since, by definition, unrealized gains are fully reinvested.

[16]If this definition of saving is employed, it is also important to adjust each taxpayer's eligibility floors and ceilings upward by the amount of capital income other than capital gains. See Bernheim and Scholz, 1992b, for a detailed discussion of this issue.

$25,000 and $35,000.[18] The universal IRA system allows all households to make deductible contributions.[19]

We compare these plans on the basis of three criteria. The first criterion is a measure of effectiveness. Specifically, for each plan, we estimate the number of households that would receive a higher after-tax rate of return on the incremental dollar of saving. We refer to these households as the IMPACT GROUP. Our second criterion is a measure of wasteful subsidization. Specifically, for each plan, we estimate the number of households that would make the maximum eligible contribution to a tax-favored account while continuing to receive the unsubsidized after-tax rate of return on the incremental dollar of investment. We refer to these households as the NO-IMPACT GROUP. Our third criterion is also a measure of wasteful subsidization: we calculate the budgetary cost of subsidizing the NO-IMPACT GROUP. We refer to this cost as the GIVEAWAY.

Our calculations are once again based on data obtained from the SCF for 1983 and 1986. The interested reader is referred to Bernheim and Scholz (1992b) for details.

Compare the effects of the policies on married couples as shown in Table 2. The top panel shows the size of the IMPACT GROUP. Overall, the PSA system provides real incentives to 2.4 million couples, roughly 90 percent more than the IRA with AGI restrictions and 30 percent more than the universal IRA. The difference is particularly pronounced in the top income quintile. By definition, the IRA with AGI caps ignores these households. Relative to the universal IRA, the PSA increases the number of couples receiving marginal incentives in the top income quintile by nearly 125 percent. Since, in this sample, over 60 percent of positive household saving is attributable to households in the top quintile of the income distribution, this improvement is particularly important.

The bottom two panels of Table 2 measure the NO-IMPACT GROUP and the cost of these ineffective subsidies. The calculations show, for example, that the PSA system would reduce the number of households in the NO-IMPACT GROUP by 1.75 million (28.2 percent) and would reduce federal expenditures on ineffective subsidies by $2.0 billion (34.0 percent), relative to the universal IRA. In terms of cost-effectiveness, the PSA system increases the ratio of the IMPACT GROUP to the GIVEAWAY by 96.5 percent overall, and by 287.2 percent (that is, by a factor of almost four) in the top income quintile. The IRA with AGI caps also effectively reduces ineffective subsidies and budgetary cost, but it achieves this reduction by excluding the very households most likely to respond to tax incentives.

Note the results for single individuals (Table 3). Under a PSA system, the size of the IMPACT GROUP would increase significantly relative to other proposals. The size of the IMPACT GROUP in the highest income quintile would more than triple. Moreover, both the size of the NO-IMPACT GROUP and the GIVEAWAY would fall relative to the universal IRA. The result is a 49.7 percent increase in overall cost-effectiveness (the ratio of the IMPACT GROUP to GIVEAWAY), and a 551.3 percent increase in cost-effectiveness for the top income quintile, relative to the universal IRA proposal.

Other Initiatives. Pension policies and tax policies do not exhaust the full range of strategies for stimulating personal saving. One particular class of policies not discussed here mer-

[18]It should be noted that the current IRA system differs from the standard IRA system considered in the text in that it phases out deductible contributions only for households that are covered by private pension plans. The current system is, therefore, a blend of a standard system and a universal IRA system.

[19]The IRA-like proposals we simulate are superior to actual IRA schemes because, in practice, IRA schemes are susceptible to tax arbitrage strategies involving borrowing and asset shifting, which our simulations do not capture.

TABLE 2[a]

A Comparison of Three Saving-Incentive Proposals, Married Couples

Simulated Effect	IRA w/AGI Cap	Universal IRA	PSA
IMPACT GROUP (in 1000s)			
Highest Income Quintile	0	102	228
Full Population	1256	1840	2388
NO-IMPACT GROUP (in 1000s)			
Highest Income Quintile	0	1416	817
Full Population	3578	6218	4467
ANNUAL GIVEAWAY (in $ millions)			
Highest Income Quintile	0	1950	1119
Full Population	2006	5861	3870
COST-EFFECTIVENESS (ratio of IMPACT group to GIVEAWAY)			
Highest Income Quintile	—	.0523	.2038
Full Population	.3510	.3139	.6171

[a]Simulations use data from the 1983-86 *Survey of Consumer Finances*. Saving and column headings are defined in the text. The PSA schedule is given in Table 1.

its further attention. An accumulating body of evidence, including that contained in this article, suggests that the behavior of many households (particularly those with lower incomes) is not well described by traditional economic theories. To some, saving decisions appear to be governed by such factors as habit, mental accounting, and self-control. Consequently, it may be possible to design more effective policies by educating the population or by exploiting the psychology of saving. The Japanese appear to have had considerable success with such a strategy during the postwar period (Horioka, 1988, and Bernheim, 1991). The development of a framework for analyzing policies of this sort is an important research priority. Bernheim (1993) provides a preliminary analysis of these issues.

CONCLUSION

The evidence presented in this article supports the view that many Americans, particularly those without a college education, save too little. Our analysis indicates that it should

TABLE 3[a]

A Comparison of Three Saving-Incentive Proposals, Single Taxpayers

Simulated Effect	IRA w/AGI Cap	Universal IRA	PSA
IMPACT GROUP (in 1000s)			
Highest Income Quintile	0	40	134
Full Population	454	603	694
NO-IMPACT GROUP (in 1000s)			
Highest Income Quintile	0	350	197
Full Population	1078	1405	1155
ANNUAL GIVEAWAY (in $ millions)			
Highest Income Quintile	0	292	151
Full Population	460	845	650
COST-EFFECTIVENESS			
Highest Income Quintile	—	.1370	.8874
Full Population	.9870	.7136	1.0677

[a]Simulations use data from the 1983-86 *Survey of Consumer Finances*. Saving and column headings are defined in the text. The PSA schedule is given in Table 1.

be possible to increase total personal saving among lower income households by encouraging the formation and expansion of private pension coverage for such families. It is doubtful that favorable tax treatment of capital income would stimulate significant additional saving by this group. Conversely, the expansion of private pensions would probably have little effect on saving by higher income households. However, these households are more likely to increase saving significantly in response to favorable tax treatment of capital income. These findings imply that the design of the current system, which links eligibility for IRAs to an AGI cap, and which provides higher income households with more complete pension coverage, ensures a minimal impact on personal saving.

Extending tax incentives for saving to higher income households is problematic. We have discussed two competing options: the universal IRA and the premium saving account (PSA). Our analysis reveals that the PSA system is a more cost-effective vehicle for providing incentives to those households most likely to respond to tax incentives.

eficial effects of the program within each population subgroup.[17] To facilitate comparisons with IRAs, we have adopted window widths of $2000 per year for single households, $2250 per year for married couples with one earner, and $4000 per year for married couples with two earners. For example, a dual-earner married couple with an AGI of $30,000 and no capital income would have a floor of $0 and a ceiling of $4000 (Table 1). In contrast, a couple with an AGI of $120,000 and dividend and interest income of $2000 would have a floor of $16,362 (.167 × $86,000 + $2000) and a ceiling of $20,362.

The standard and universal IRA systems differ from the PSA proposal in that they anchor the eligibility window at $0 for all income classes and make no adjustment for capital income. The standard IRA system phases out deductible contributions for married couples with incomes between $40,000 and $50,000 and for single taxpayers with incomes between

[17]Note that the floor rises with income at different rates for married couples (16.7 cents for each dollar of income over $34,000) and single individuals (34 cents for each dollar of income over $42,000). Since actual patterns of saving differ by marital status, different schedules must be used to maximize the beneficial effects of the program.

TABLE 1[a]

Deductible Contribution Formula

Married Couples

If your income is	Deductible Qualified Contribution Floor (Added to Capital Income)	Deductible Qualified Contribution Ceiling (Added to Floor)
Less than $34,000	0	$2250 or $4000
Greater than $34,000	.167×(Income-34,000)	$2250 or $4000

Single Households

If your income is	Deductible Qualified Contribution Floor (Added to Capital Income)	Deductible Qualified Contribution Ceiling (Added to Floor)
Less than $42,000	0	$2000
Greater than $42,000	.34×(Income-42,000)	$2000

[a]For the purpose of comparison with IRAs, married couples with one earner are allowed to contribute $2250 and married couples with two earners can contribute $4000. In the actual implementation of this proposal we see no compelling reason to make this distinction.

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